DR. KURT RICHEBÄCHER

Muehlegasse 33
CH-8001 Zuerich
Switzerland

CURRENCIES AND CREDIT MARKETS

No.195/ July, 1989

Continued large U.S. trade deficits are likely to lead to longer term problems in large part associated with the financing of the deficits, and to impose adjustment costs arising from the macroeconomic changes in spending, exchange rates, and other variables needed to restore equilibrium.

Economic Consequences of Continued U.S. External Deficits
Federal Reserve Bank of New York, Quarterly Review
Winter-Spring 1989

HIGHLIGHTS

Inflation can have very different channels of expression. The inflation of the 1980s is fashioned in different clothes. Unprecedented credit excesses have been largely translated into soaring imports and gaping trade imbalances.

The large capital inflows that then result are grossly counterproductive. Not only do they checkmate a tight monetary policy, they also diminish domestic savings by boosting consumption while all the while eroding financial stability.

Effectively, the supply side of the economy is relegated to "runt" status as consumption crowds out investment from the milk of savings and retards development of productive capabilities.

One cannot forewarn often enough about what may lie at the root of the chronic inflationary malaise that threatens the United States economy. Grossly inadequate savings, grossly inadequate investment, (which in turn contributes to poor productivity growth) still infests the North American landscape.

At long last, the Fed is now facing the classical late-cycle dilemma where it has to choose between further curbing an inflation that is running at its fastest pace in this expansion or trying to revive the economy.

While in our view the soft landing is the one scenario that's almost impossible, the Fed's urgent easing actions in recent weeks prompts review of a third scenario.

At the moment what we see in the United States is the normal cyclical weakening at the end of a boom. But this time there are three lurking dangers that could leap out of the deep should ever a recession ensue.

The high-altitude bombing many currency speculators suffered recently during the downdraught of the U.S. dollar makes it abundantly clear that the prior surge was indeed a speculative bubble, just as we had suspected.

Very likely, the U.S. dollar is headed sharply lower over the next few months. The very tightness of recent monetary tightness has also set the stage for a looser policy as the U.S. economy weakens. As a result, shrinking interest differentials should drastically reduce the attractiveness of the U.S dollar.

THE DUEL OF THE ALTER EGOS: ROTATING MANIAS VERSUS MANIC WORRIES

The high-altitude bombing many currency speculators suffered during the recent downdraught of the U.S. dollar makes it abundantly clear that the prior surge was indeed a speculative bubble just as we had suspected. The blow-off of the dollar against the hard currencies had all the markings of a speculative mania: crazy theories, panic, loss of control (by the central banks in this case), high volume, and mob psychology all fired-up on the mystical strengths of chart patterns.

There was enormous turnover in the New York currency-exchange markets, dollar-volume having shot up to an average of $850 billion per day for the two weeks ending June 14th. If one were to combine cash, options and futures transactions, trading may well have reached over $1 trillion each day - a new record for the financial history books!

No where in any of this can we find solid fundamental justification for this recent attack on the hard-currencies of Germany and Japan. The fact that the domestic financial markets of these fundamentally strong economies hardly suffered at all may prove that persuasion. One can only wonder what would have happened if an attack of similar psychological dimensions were to be directed at a more deserving currency. Now that the tornado-like mania has cut its swath from stocks to high-yielding currencies to bonds, could it be possible that the next mania might hit the hard-currencies?

THE CONFIDENCE AND QUESTION OF THE SOFT LANDING

What has been the most important occurrence for financial markets recently? As it happens, again, it's neither an economic or financial event but rather a psychological one. It's the change in the consensus view on the resilience of the U.S. economy. Exuberance and exaltation has given way to inkling worries over recession.

The previous, almost unanimous, euphoria was happily consoled in the widely accepted notion that what lies ahead is the best of all possible worlds - the utopia of the wonderful "soft landing". According to the consensus view, the U.S. economy would slow just enough to lower inflation and interest rates sufficiently enough to get out of harms way...and it should be added, without any undue economic hardships.

The point to wake up to in all of this misapplied jargon and jingoism is that most apostles of the "soft-landing" view are willing to accept 5% inflation rates as "non-inflationary". Quite seriously, rather than belabour the semantics, we can only say that mincing words is one thing but mixing numbers is quite another.

THE EFFECTS OF PAST EXCESSES WEAR NEW CLOTHES

As our readers know, we have often expressed our disagreement with the euphoria that has enervated markets. An old rule of thumb states that the length and severity of any recession depends largely on the magnitude of the economic and financial maladjustments and imbalances which developed during the preceding boom. The implications of this venerable rule directly counter current thinking. Rather than proving the case for a suspended state of perpetual economic

prosperity, the longer excesses are tolerated and the more protracted imbalances become, the more wrenching the experience is likely to be when the pendulum again pulls back to equilibrium.

Every recession has its ultimate origin in the financial excesses that occur in the preceding boom. The cause can invariably be traced to one thing and one thing only: credit excesses. As always, credit is allowed to expand out of proportion to available savings. In the first place, excess credit creation always means excessive *debt* accumulation. But, its effect on the economy may take many different forms. The specific effects depend on where the inflated money supply is spent in the first place... whether that may be securities, real assets, consumer goods, government largesse (ie. budget deficits), wages, imported goods or whatever else.

THE DIFFERENT FACES OF INFLATION

As a result, inflation can have very different manifestations and channels. At the centre of the 1970s inflation was an over-expansion of credit for investment purposes (mainly real estate). As the economies overheated, it set in motion the well-known inflation spiral which culminated in a widespread and highly visible rise in "general price levels".

The inflation of the 1980s went into a totally different channel. Due to the fact that Japan, Germany and other countries pursued more restrictive monetary policies, the credit excesses in the United States and other countries translated largely into soaring imports and gaping trade imbalances instead of venting its forces mainly on domestic "price levels". The release valve of trade deficits (or the export of excess dollars resulting from high credit growth) funnels dollars into international hands. These funds then flow back in the form of foreign stock and bond purchases, takeovers, interbank credits, "euro" deposits... etc.

By the way, when one thinks of it, isn't this mechanism a marvellous wealth-creating devise. Foreigners not only deliver the trade goods but also contribute to the illusion of wealth through asset price inflation.

Unfortunately, the juicy apple has a few worms and the golden goose is liable to some fatigue. There are at least three parasites that threaten to hasten the apple's fall: firstly, excessive debt accumulation; second, overvaluation of real assets (real estate, stock, bonds) that also, not co-incidentally, collateralizes much debt; and third, the invidious effect of capital consumption as the combination of high interest rates and high exchange rates tends to raise consumption at the expense of investment.

THE MOST CRITICAL QUESTIONS ARE HARDLY DISCUSSED

Not by accident, all countries with large current-account deficits and high interest rates show the same disease eroding the foundations of their long-term economic strength: exceptionally high levels of consumption, sharply lower net savings and net investment rates, and asset-price inflation - all as an outflow of their domestic credit and debt excesses. While asset-price inflation creates tremendous paper wealth (further stimulating the consumer through the wealth effects) the productive base of these countries lags.

Most North American economists conclude that the U.S. current-account deficit is "sustainable" for several years at least because foreign investors would be only too willing to provide financing indefinitely. But, sustainability is not necessarily the same as desirability.

In the trample of the eagerness to prove the former theories, forgotten are two far more important issues: firstly, the ongoing consequences of persistently large external deficits for monetary policy, interest rates and financial market conditions in the longer terms; and secondly, the long-term implications of overconsumption, under-saving and under-investment for future economic growth potential, wealth and living standards.

THE FORGOTTEN SUPPLY SIDE

Many economists seem to think that drawing on foreign savings is an acceptable and fortuitous substitute for deficient domestic savings and one that happily allows them to eat their cake and have it too. But, contrary to widespread opinion, the reinforcement of foreign savings by no means avoids a "crowding out".

Just as with the inflationary pressures of excessive credit growth, "crowding out" simply finds a different channel of expression. If a country relies heavily on foreign capital inflows, its overall balance of payments still has to balance, and that implies that it has to develop a corresponding current-account deficit. Imports have to exceed exports. Consequently, to the extent that a country uses foreign savings, it crowds out its own export and import-competing industries.

The Corporate Sector Pays Now...... The basic point is that the high interest rates and high exchange rates squeeze the corporate sector - primarily foreign trade and the investment - while the consumer reaps substantial benefits in the form of cheap imports and positive wealth effects attributable to large capital imports.

The Consumer Pays Later. Obviously, however, all these benefits to the consumer can only be temporary and short-run. Over time, the consumer inevitably has to pay for these benefits through rising unemployment and falling living standards as falling investment ratios undermine future productivity.

The economic damage occurs because the price system - more precisely the combination of high interest rates and high exchange rates - diverts resources away from investment toward consumption. Lower investment means lower growth of the capital stock which, in turn, is sure to precipitate a shortfall in productivity growth and with it, a deterioration in the relative standard of living.

Anybody who has studied financial history knows that bombastic international borrowing binges (or lending orgies) have always ended in ignominious disaster. Why? Because they have mostly been the accessory to excess consumption. It happened to the developing nations (LDC's) during recent decades, also during the 1920s, and it is happening now to the countries of United States, Canada, Australia, Britain and others.

A SOBERING ADMONITION FROM THE PAST. IT"S ALL HAPPENED BEFORE.

A famous economist, Joseph Schumpeter, once remarked about one-time huge capital flows into Germany as follows. His description of that earlier situation is chillingly familiar and merits careful attention.

> **"The effects of these capital imports are clear: not only were adjustments prevented, but the pulse of German business became dependent on the rate of flow of foreign funds; with foreign banks financing a considerable part of investment and current spending in Germany, the policy of the central bank was checkmated; the consumption-boom was powerfully propelled; and of course, a financial situation was created that was in constant danger of collapse on comparatively small provocation. ...Thus, part of the foreign credits effected precisely what an issue of greenbacks might have done; in a sense, the foreign credits camouflaged "inflation" by producing its results under the surface of an apparently very "sound" monetary system."**

Quite simply, the shoe fits perfectly. It is clear that large capital inflows are grossly counterproductive. Not only do they checkmate a tight monetary policy, they also diminish domestic savings by boosting consumption while all the while eroding financial stability.

The whole phenomenon of the cumulative damages, excesses and industrial maladjustments that are being embedded in the economies of countries as a result of credit excesses and large external deficits deserves a much closer look. However, we should first review another important situation: that of worldwide cyclical and monetary trends.

INTERNATIONAL ECONOMIES PARTING COMPANY

After a year of uniformly strong economic growth, the global pattern has begun to diverge. While buoyant growth continues in Germany and Japan, a significant slowdown has developed in the United States and Britain. Furthermore, all signs point to continued (if not progressive) weakening in the United States, just as in Britain. But, while market opinion has already turned highly critical on both the British economy and economic policy, the opinion about the U.S. economy remains remarkably optimistic despite the first sounds of knocking knees in some quarters.

To be honest, it has always been our contention that in an environment of a weakening economy the Federal Reserve would quickly capitulate and loosen the money spigots. Recent Fed actions have certainly met our expectations. However, the speed at which the reaction took place in itself is bewildering.

EVIDENCE FOR SLOWING INFLATION IS STILL INCONCLUSIVE

Both Wall Street and the Fed seem to be quick to grab any flimsy evidence that inflation is moderating. Week after week, rising inflation rates are systematically belittled by pointing to the above-average price increases in oil and farm prices.

In reality, without the optimistic eye-shades, the inflation picture looks much worse than most people think. Against a year ago, the consumer price index has

risen 5.4%. But during the three months ended May 1989, the index rose at a seasonally adjusted annual rate of 7.1%. To say that this is mainly due to a surge in oil and food prices is a gross overstatement. The truth is that one large component - housing - is keeping the index artificially low.

Housing accounts for 42% of the index and shows a very modest rise of 3.7% against a year ago and an annualized 3.3% over the last three months. This measure covers all housing costs including fuel. On the other hand, motor fuel, which has risen in price by 18% has a weight of 3% in the index.

TRIALS FOR THE FED

As for the U.S. dollar, no doubt, a great plus was the anti-inflationary credibility of Mr. Greenspan and the Fed. But we have always stressed that it is easy to gain credibility when a strong economy demands higher interest rates. The true test for the resolve of a central bank always comes at the end of a cyclical upswing when the economy weakens while inflation still rises.

At long last, the Fed is now facing the classical late-cycle dilemma where it has to choose between further curbing an inflation that is running at its fastest pace in this expansion or trying to revive the economy. Given the almost panicky reaction of the Fed to the first signs of an economic weakening even though employment is still rising by about 200,000 per month, one has to wonder how long it will take the bank to lose its anti-inflation creditability. As in the past, and contrary to the well publicized protestations, the Fed obviously prefers to err on the side of accommodation though the economy is still near full employment of labour and capital.

After one of the longest cyclical upswings in its history one should think that the Americans could take two or three quarters of zero growth in stride. But, it isn't only American politicians that seem to have a pathological fear of anything that might be called a recession.

It is true, though, that recent economic data look pretty bad generally. To us that is little surprise. We had picked up the scent of a slowing economy much earlier in the year even as most were still fretting over the perception of an over-heating economy. Now, housing starts are at their lowest level since 1982. Retail sales volume are no higher than a year ago, even less on a real per capita basis. Auto sales have slumped and last but not least, new orders cast a dismal pall over future production prospects. Total orders of all manufacturing industries are up by 7.8% against a year ago. Orders for capital goods, excluding aircraft, are a mere 4.5% higher. After adjusting for inflation, that speaks of zero gain for activity.

Judging from these fast fading figures it may appear that the U.S. economy is headed for a recession as early as the next quarter, let alone next year. However, it should be remembered that all these weak data relates to manufacturing industries which account for no more than 22% of U.S. GNP and only 18% of total employment. About 75% of GNP and almost 80% of employment is in services which includes fairly substantial expenditure items that increase automatically like medical care, housing, transportation, etc.

FORECAST A LA CARTE. MOST STILL PREFER THEM SOFT AND OVER EASY.

Presently, Wall Street gurus are offering three different scenarios: first, the Fed will engineer slower growth while avoiding recession (soft landing); second, there will be slow or no growth but with inflation staying on the high side (stagflation); and third, a desperate monetary easing and plunging interest rates produce a new inflationary burst of economic growth followed by a recession in 1990 as the Fed is finally forced to extinguish rampant inflation.

So far, the soft-landing camp is still dominant, manifesting itself in an ultra-bullish bond market. In our view, the soft landing is the one scenario that's almost impossible. Although aware of the high risk of recession, we have always leaned towards the second scenario of stagflation. However, the quick easing by the Fed and the overreaction of the markets in pushing long-term bond yields sharply down to barely 8% has increased our anxiety. There might now be a greater chance for the third scenario...a "dash-smash" scenario.

DANGERS OF A RECESSION ARE THREE

At the moment what we see in the United States is the normal cyclical weakening at the end of a boom. That in itself, of course, would not normally be cause for much concern. But this time, it isn't just a few notable thinkers who suspect that there possibly might be some lurking potential dangers that could leap out of the deep should ever a recession ensue.

The way we see it, there are at least three serious hazards that compound the risks of any recession. Firstly, as is well known and feared, a recession is sure to collide with a tidal wave of debt that spans all three major sectors: government, corporate and consumer.

The second hazard is the longer-running effects of the "hollowing-out" of the U.S. economy on the supply side caused through over-consumption, under-investment and under-savings. What that means is seriously impaired productivity which will ultimately translate into lower income growth and reduced debt quality.

The third element that should not be overlooked is the increasing fragility of the financial system. Certainly, the Saving and Loans (S&L's) may be the weakest link but by no means the only fragile link. One might remember Schumpeter's statement regarding foreign capital inflows we quoted earlier: "...(that) a financial system was created that was in constant danger of collapse on comparatively small provocation...". Psychology and confidence plays a very large role.

BACK TO THE SUPPLY SIDE. IT MAY COMPOUND THE CYCLICAL.

Apparently, one cannot forewarn often enough about what may lie at the root of the chronic malaise that threatens the United States economy. The combination of over-indebtedness, over-consumption, grossly inadequate savings and investment, (which in turn contributes to poor productivity growth) is a serious long-term problem of great dimensions. Recognition of those dangerous deficiencies, after all, prompted the heralded goals and remedies of Reagonomics. Despite good intentions, but paradoxically because of Reagonomics, U.S. savings sank to the lowest ebb ever during peacetime as well as the lowest levels in the industrial world (with the possible exception of Britain).

The point to recognize is that the longer-run may already be rapidly becoming a short-run issue. That is why we are forced to reckon with the possibility the possibility of a long and severe recession.

DEEP IMPACT ON PRODUCTION ECONOMIES

During the present recovery, U.S. net investment has averaged barely 5% of GNP, nearly two percentage points below the postwar average. But what makes this decline a disaster is the fact that all of the shrinkage occurred in the business sector and mainly manufacturing at that. In fact, net manufacturing investment showed no increase from 1982 through 1987 despite the boom. As a result, the amount of capital per worker in both the whole economy and the manufacturing sector has been essentially flat. If investment had continued to advance at the trend rate of the 1968-82 period, capital per worker in the manufacturing sector would now be about 25% higher.

Another Example of Supply-Side Folly. The other major country where manufacturing growth and investment proves an unmitigated disaster is Britain. While British manufacturing is supposed to have achieved a "productivity miracle", it has suffered a calamitous reduction in size. Manufacturing output only recovered its 1979 level in 1987 and fixed investment in manufacturing has only just reached its pre-1979 level in real terms. What explains most of the productivity miracle is that more old plant was scrapped as it wore out or became uneconomic. So, net investment has been negative for most of the 1980s. Manufacturers stock of productive assets, factories, plant and machinery fell from 48% of GNP in 1979 to 38% in 1987. Employment in manufacturing shrank even faster than the capital stock - from around 8 million in 1979 to under 5 million in 1988.

THE CONTINUING SUPPLY-SIDE IMPLICATIONS FOR TRADE DEFICITS

Dollar-bulls like to tell us that U.S. labour costs in manufacturing are now well below those of major competitor countries. That may be true. But the key condition for the longer-term improvement of the U.S. trade account is that a favourable cost position is backed up by sufficient capacity growth to accommodate higher exports and increasing import-substitution. Blatantly however, that process is not at work.

At any rate, trade adjustment has generally stalled. In most cases, imbalances are deteriorating again partly due to shifts in net interest income implied by the widening external asset positions. While the adjustment of the U.S. deficit has continued as the growth of domestic demand has sharply slowed, even the most optimistic projections put next year's current account deficit no lower than $115 billion. By contrast, West Germany's current account surplus during the first five months of the year amounted to DM 45.6 billion versus only DM 32.3 billion the same period last year, and still German export orders are surging at double-digit rates. U.S. export orders, on the other hand - according to the nation's purchasing managers - are at the lowest reading since the index was initiated in January 1988.

THE DEMAND FOR DOLLAR ASSETS

Given the persistence of large trade (even growing) imbalances the key question now becomes whether investors and central authorities in surplus countries will

continue to finance these deficits at present exchange rates. Gauging from the splendid performances of all the high-yielding currencies it appears market opinion reflects little concern.

As usual, many economists eagerly provide all kinds of pandering theories that support and foster an air of sanguine complacency, particularly concerning the U.S. economy and currency. A popular postulation is that world investors are so hungry for dollar-assets that the U.S. currency will rise even in spite of persistent current account deficits greater than $100 billion over coming years.

Obviously, many have forgotten that it was as recently as 1987 that the entire U.S. external deficit had to be financed by the dollar purchases of foreign central banks because private and voluntary investors were no where to be seen. Even after the stabilizing Louvre Accord of February 1987 it took more than a full year of massive central bank interventions (amounting to more than $100 billion) and a concurrent sharp rise in U.S. interest rates to restore confidence in the U.S. dollar and coax back private lenders and investors into dollar markets.

But the triumph gained by central authorities in convincing markets of their ability to successfully defend currencies unintentionally created a new problem. With the promise of exchange rate stability, the high nominal interest rates of the deficit countries became irresistible. Capital from low-yielding, hard-currency countries began to flood high-yielding countries with little regard for inflation and gapping external balances.

We quote from our April letter: "..given the fact that deficit countries have high interest rates and that surplus countries have low interest rates, this artificial exchange rate stabilization essentially ends with the perverse effect that currencies move contrary to their underlying fundamentals. As capital flows are powerfully lured by the siren call of high interest rates - even to the point of overwhelming trade deficits - the currencies of these countries appreciate. Meanwhile, the low-yielding currencies of surplus countries depreciate in complete disdain of what would otherwise be considered attractive fundamentals."

THE ROLE AND MECHANISM OF THE CURRENCY BLOCKS

We keep pointing out, of course, that the U.S. dollar hasn't been the only beneficiary of this new currency regime. Lenders and investors from hard-currency countries have bought high-yielding currencies almost indiscriminately. What is happening has no parallel in history: that countries with ever increasing external deficits attract ever increasing foreign capital and experience ever increasing currencies.

The rise of these currencies reveals that capital inflows greatly exceed the financing requirements of their current-account deficits. As a consequence, some central banks did intervene by selling their own currency - mainly against the U.S. dollar - to restrain the rise of their own currencies. In other words, they too bought and accumulated large amounts of dollars.

This brings us to an important point of distinction between the high-yielding currencies: that is to which currency bloc they are linked - to the dollar-bloc or the D-Mark bloc. For bond investors that will be the most important question since the currencies of each bloc will tend to rise and fall together.

Let us first take a look at the dollar bloc. For international bond investors the big play has been in three markets: the United States, Canada, and Australia. In 1988, net foreign private purchases of U.S. bonds totalled about $72 billion. In addition, foreign central banks increased their holdings of U.S. Treasury paper by $39 billion. In the case of Canada, net foreign purchases of fixed income instruments amounted to approximately $19 billion, proportionately probably even higher that U.S. levels. Flows of similar magnitude went into Australian bonds yielding 13 to 14%.

If one wishes to stay ahead of the next major movement in the currency and financial markets it is essential that one becomes familiar with the mechanism that ties the dollar-bloc currencies. That's because if they fall they will tend to fall in a domino-like fashion. This link is caused by the two functions of the U.S. dollar (as we've one explained before in an earlier letter): firstly, its intermediary role in cross-trading between other currencies (especially between the two major blocs), and secondly, from its employ as the predominant international reserve currency.

The intermediary role arises from the fact that all trading between different currencies outside of the European Monetary System (EMS) is carried out through the intermediary conduit of the U.S. dollar. For example, when a German investor buys Canadian bonds, his bank will first turn his D-Mark funds into U.S. dollars, which it then uses to buy Canadian dollars.

Though the U.S. the dollar base is not affected directly by this transaction, the result is that the U.S. dollar tends to weaken against Canadian dollars and at the same time strengthen against the D-mark. The offset is that the Canadian central bank has, in turn, bought U.S. dollars. This same process applies to a number of other central banks, among them the Bank of England, who all have been heavy buyers of U.S. dollars adding to its strength.

The point to see is that this mechanism is liable to cut both ways. If any one of the dollar-bloc countries faces an attack on its currency its central bank will be sure to dump dollars and may very likely cause dollars to be dumped against hard-currencies.

SUMMARY CONCLUSIONS

For now, financial markets are buoyed by the hope for a further Fed easing. There is just one problem with this euphoria. Financial markets seem to have forgotten that they exist within an interlinked global economy and that everything will depend on the willingness of voluntary foreign investors.

The consensus view that a softening of the U.S. economy with attendant falling interest rates will leave capital inflows untouched is incredibly naïve. Experience says that foreign investors will take flight because they have always associated falling interest rates with a falling currency.

The dollar-DM relationship has always been influenced by two reciprocating cycles: that of the capital account and the trade account. The pro-cyclical influences of the capital account tend to dwarf the counter-cyclical trend of the trade accounts and thus tends to be the dominating influence on exchange rate movements. Thus to conclude that a slowing economy with attendant lower import

levels will not negatively influence the U.S. dollar is patently ridiculous.

One last point regarding the plight of monetary policy that deficit-countries face during a recession. Here history serves up a host of lessons and examples. The dilemma begins when capital inflows weaken and bring down high-flying exchange rates thus triggering a "vicious cycle" of higher inflation, lower confidence and sagging currencies. Central banks then become prisoners of their currencies and are forced to place a high priority on exchange rate stabilization. Invariably what that means is high interest rates even as the economy slows.

As a rule , central banks of countries with large current account deficits have to raise their interest rates to hold and attract foreign capital. Presently, now that the speculative euphoria stages have receded, we see that relationship at work in at least three countries: Britain, Australia and New Zealand. The trouble is that interest rate increases (as we discussed at length in the last letter) tend to have little impact from a position of weakness. All three countries now face sky-high interest rates primarily to prevent further weakening currencies.

Of these, New Zealand is the most advanced. The country has been in a deep recession since 1987 and yet inflation is still at 6%. And just to maintain a stable currency, the country faces interest rates in the 12-13% range.

As far as the U.S. dollar is concerned, market sentiment has not yet really turned bearish because most people still cling to the hope of a "soft landing". The critical phase for the U.S. dollar will begin when the alarms bells of an economy sliding into recession begin tolling and confidence in the Fed and the fundamental health of the economy begins to wane. It is then that we shall see new lows against the D-Mark bloc currencies.

We find it most interesting to note that the "soft landing" ideology is gaining its greatest amount of converts on the strength of evidence pointing to an economy that is generally weaker than is expected.

Let us state one point, explicitly and categorically: the soft landing scenario is virtually impossible. Large external deficits that reflect overconsumption and over-borrowing are the surest recipe, not only for recession, but for the long-term economic decline of a country.

Analyzing cyclical forces as well as economic and financial fundamentals for the major countries, we have come to the conclusion that 1990 will very likely be the year for the whole D-Mark bloc. Continental Europe is booming, pulled by the locomotive of the German economy. The crucial point of difference to remember in any comparison to the notorious deficit countries is that the European boom is fed primarily by investment and takes place against a backdrop of low inflation. Continental Europe has achieved an economic composition of stability and low inflation unequalled since the 1960s.

Among international bond markets, our choice for the second half of 1989 and 1990 would be the D-Mark-bloc markets. As ever, the policies of the Bundesbank remains the key to all the European markets. There is no danger of a major monetary tightening. The last raise in the discount rate actually buoyed the German bond

market. At same time, we would also expect that the Bundesbank will not match any easing by the Fed.

Within the D-Mark bloc, we suggest that the prudent investor would choose between German, Dutch, and French bonds. Dutch government bonds yield a little more than German government bonds while French bonds appear as the safest high-yield within the group, now effectively yielding 8.7% against 6.8% on German bonds and 7.2% on Dutch bonds.

We have to admit that the timing of future events is more difficult to predict than ever. Excesses - as large as they may be - can persist as long as there are oblivious and compliant players. The fact that credit excesses have taken on the image of trade deficits rather than the more familiar effect of domestic price inflation fosters false optimism and complacency. Most certainly, an accident of some kind will be required to jolt people back to a sense of reality.

All the same, we must stress that there are enormous risks building up - certainly more than most perceive. The world economy is out of balance as never before.

Publisher/Editor: Dr. Kurt Richebächer
Muehlegasse 33, CH-8001 Zuerich, Switzerland

Annual Subscription:
SFr. 600.–/US-Dollar 400.– for subscribers outside Europe.

Languages: German/English